

Southwest Economy



Texas Economy Stalled by Recession

Texas followed the nation into recovery at the beginning of the year, but the state's job losses resumed in May, even as the nation continued its anemic recovery. The current Texas recession is shallower than previous ones but will probably last longer. The extent to which Texas remains in recession depends greatly on the strength of the national and global economies.

If we define recession as two consecutive quarters of negative employment growth coincident with gross state product (GSP) declines in at least one quarter, Texas went into recession in April 2001. Employment declined in the last three quarters of 2001, picked up in first quarter 2002, then declined again in the second and third quarters (*Chart 1*). The September employment numbers (the latest data available) show a slight decline of 0.4 percent (annualized) for total employment and a greater drop of 1.1 percent for private employment. Employment is down 1.7 percent (annualized) for the quarter and 0.2 percent (annualized) year-to-date.

Looking at output, the Dallas Fed's estimate of Texas GSP growth looks similar to U.S. GDP

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INSIDE:
*Have REITs Helped Tame
Texas Real Estate?*

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*Texas Exports
Finally Pick Up
but Have Far to Go*

The National Economy: Heading for a Dip?

The recession began in March 2001 and despite the events of September 11, appears to have ended the following November. How far have we come since November 2001? And where are we headed?

The key features of the apparent expansion have been slow growth in output and almost nonexistent growth in employment. The former is unsurprising, given the mildness of the 2001 recession. The latter, however, contrasts sharply with the usual pattern of post-World War II expansions. In terms of employment growth, the recovery from the 2001 recession is shaping up to be a repeat of the jobless recovery that followed the 1990-91 recession.

Troubling as the lack of job growth has been, more worrisome still is evidence that the pace of the expansion has cooled, beginning around July.

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The National Economy: Heading for a Dip?

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This evidence, which has come primarily from measures of production, has raised fears of a double-dip recession.

Over the same period, though, barometers of the state of demand have remained generally positive. Obviously, production and demand cannot go in opposite directions for long—particularly since inventories have been pared down at all stages of the economy's supply chain. At some point, either production will have to pick up or demand growth will have to slow. Which side will win this tug-of-war is unclear. At the time this article was written, the available data were not signaling an imminent second dip.

Another notable feature of the ongoing expansion has been the falling rate of inflation the economy has experienced over the past year. Since mid-2001, what had been a marked acceleration in inflation has turned, suddenly, into a marked deceleration, to the point where concerns about *deflation* are surfacing.

This article presents a status report on the health of the apparent recovery and discusses some of the factors influencing the economy's near-term direction. It also looks at the economy's recent inflation performance and the deflation concerns it has engendered.

A Weak Expansion

While the National Bureau of Economic Research is the final arbiter of the dates of U.S. recessions and expansions—and a determination from them is still probably months away—every indication is that the 2001 recession ended last November.

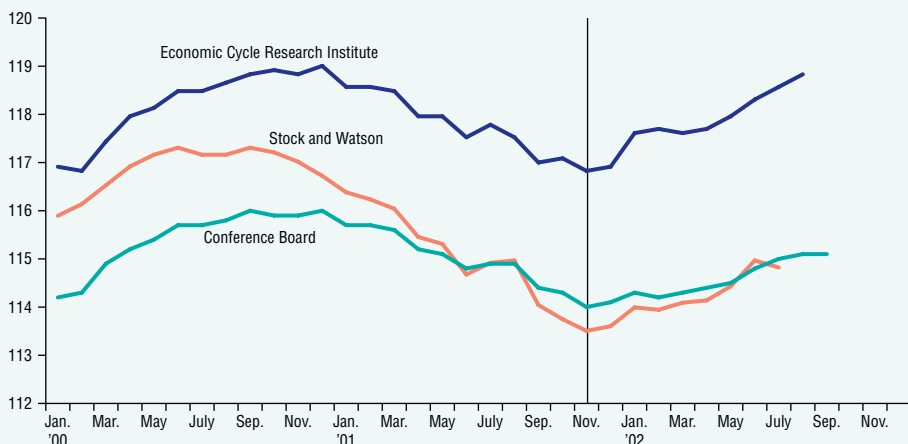
Chart 1 shows three coincident indexes of economic activity—from the Conference Board, the Economic Cycle Research Institute and economists James Stock and Mark Watson of Harvard and Princeton universities, respectively. Coincident indexes amalgamate a large number of economic variables in an attempt to measure the overall level of economic activity. All three indexes hit bottom in November 2001—shown by the vertical line in the chart—after which they begin to rise.

The pace of output growth in this expansion, though, has been slow. GDP grew 3 percent in the year after its third quarter 2001 trough. By comparison, output growth over the first year of the average post-World War II expansion is closer to 6 percent. The slow output growth in the current expansion is, however, consistent with the mildness of the 2001 downturn.

Chart 1

Coincident Indexes Point to Trough in November 2001

Indexes, 1996 = 100

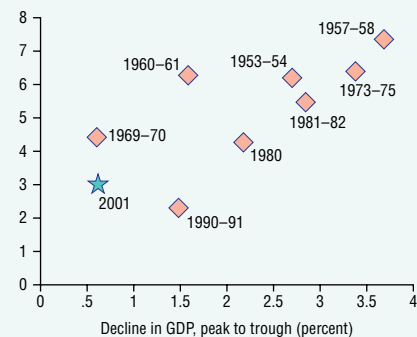


SOURCES: The Conference Board; Economic Cycle Research Institute; James Stock and Mark Watson.

Chart 2

The Milder the Recession, the Weaker the Recovery

Growth in GDP, first year after GDP trough (percent)



SOURCES: Bureau of Economic Analysis; author's calculations.

The Guitar String Theory of Business Cycles

As a rule, mild recessions make for weak recoveries and, conversely, deep recessions make for strong recoveries. Milton Friedman dubbed this the guitar string theory of business cycles: The smaller the pluck downward, the weaker the snap back. By most measures, the 2001 recession was a very small pluck; hence, we shouldn't expect a sharp snap back. Measuring a recession's severity by the percentage decline in GDP from its peak to its trough ranks the 2001 recession as nearly the mildest of the postwar period.

The scatter plot in Chart 2 illustrates the guitar string theory. Each point corresponds to a recession/expansion episode. Points further to the right correspond to deeper recessions, and those higher up correspond to stronger recoveries. The star represents the most recent episode. While the guitar string relationship is looser for milder recessions, output growth following the 2001 recession has not deviated greatly from the historical pattern.

Another Jobless Recovery?

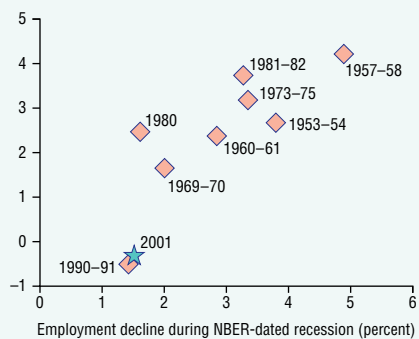
What has been surprising has been the sluggish employment growth. Private payrolls continued to fall for several months after the overall economy began to recover and are still below their November 2001 level. Since April—the point when employment appears to have turned the corner—the economy has gained a mere 83,000 jobs.

Financial market indicators are sending mixed signals about the future pace of economic growth.

Chart 3

Jobless Recovery Redux?

Growth in employment, first 11 months of NBER-dated expansion (percent)



SOURCES: Bureau of Labor Statistics; author's calculations.

Could this simply be the guitar string theory again? The answer is no; employment growth has been slow, even after accounting for the mildness of the downturn. The scatter plot in Chart 3 is similar to the one in Chart 2 except that it measures severity of recession and strength of rebound in terms of employment's percentage decline during the recession and percentage growth over the first 11 months of expansion. Clearly, the two most recent episodes are not like the others, and our current experience is nearly a repeat of the 1990-91 recession and the jobless recovery that followed.

Cooling Production Since July

While the slow pace of output growth so far is probably not cause for concern, evidence of a recent cooling in the pace of the expansion certainly is. This evidence, which began to accumulate in late summer, has come primarily from the economy's production side.

For example, surveys of firms' purchasing managers conducted by the Institute for Supply Management (formerly the National Association of Purchasing Management) indicate a significant deceleration in both the manufacturing and service sectors since July. Industrial production, measured by the Federal Reserve Board, fell in August and September after having registered seven consecutive monthly increases. Aggregate weekly hours worked, measured by the Bureau of Labor Statistics, also dipped in late summer.

Are We Headed for a Second Dip?

Is the economy tipping back into recession? While concern is definitely warranted, the data do not—so far—point to a double-dip scenario. First, while most indexes of leading indicators show declines over the past few months, those declines have been small. Meanwhile, financial market indicators are sending mixed signals about the future pace of economic growth.

On the plus side, the yield spread—the difference between interest rates of long-maturity and short-maturity bonds—remains high. Economic theory tells us that when interest rates on long bonds exceed interest rates on short bonds, markets are expecting short rates to rise, something generally associated with more rapid economic growth. Thus, a high yield spread generally signals a faster pace of economic activity down the road.

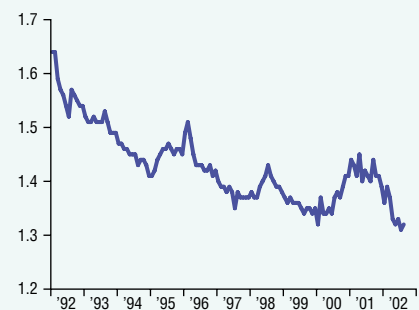
On the other hand, the junk-bond spread—the difference between interest rates paid by issuers of junk bonds and issuers of high-quality corporate debt—has widened since spring. A bigger junk-bond spread indicates tighter credit conditions for below-investment-grade firms, and, while this indicator has a short track record, increases in it have generally portended slower economic growth.

A final factor to consider when weighing the possibility of a second dip is the position of inventories. The great inventory reduction that began in early 2001 seems to have run its course, with

Chart 4

Inventory Reduction in Manufacturing Seems Nearly Complete

Inventory-to-sales ratio



SOURCE: Census Bureau.

inventories bottoming out at all stages of the economy's supply chain. At the manufacturing stage, the ratio of inventories to sales—currently around \$1.30 in inventories for every \$1 in sales—is back to its prerecession level (*Chart 4*).

With inventories stripped down, production will have to increase if demand growth continues.

The Health of Demand

Hence, we turn to demand. It is from here that most of the good news has been coming lately. Firms' investment in capital has recently shown some spark of life, while consumer spending continues to grow at a moderate pace.

The 2001 downturn was, if not an investment-led recession, certainly an investment-fed recession. The declines in just fixed investment—let alone inventories—more than accounted for all the GDP decline in the three quarters in which output fell.

Investment has begun to rebound—at least somewhat. Business fixed investment fell in the second quarter of 2002, though by a much smaller amount than in prior quarters. Within fixed investment—which includes equipment, software and structures—investment in equipment and software grew in the second quarter for the first time since mid-2000. Within equipment and software, the information-processing, or high-tech, portion registered growth in both the first and second quarters. These components are not growing at nearly their prerecession rates, but they are growing nonetheless.

Can investment growth be maintained? The outlook here is unclear. On the plus side, corporate net cash flow over the past few quarters has been up a bit relative to its level of the past few years. On the other hand, Census Bureau data on shipments of capital goods and orders for new capital show little evidence of forward momentum. In particular, the value of new orders has generally been below the value of shipments throughout 2002—that is, manufacturers of capital goods have been getting slightly less than a dollar in new machinery orders for every dollar's worth of machinery they ship. This would seem to portend slower future growth in capital goods shipments.

What about consumers? Thus far in the expansion they are a bit bowed, but

unbroken. After slowing late last year, growth has rebounded in both consumption spending and income. Retail sales have been characterized by large boom-to-bust swings owing to the on-again, off-again incentive programs of auto manufacturers. However, monthly sales measures that exclude motor vehicles have shown a much steadier, moderate rate of growth since late last year, though with some evidence of slowing in August and September.

Will consumers continue to spend? The picture here is probably brighter than it is for firms. First, disposable income has been growing faster than consumer spending for most of 2002. As a result, households' savings rates have risen considerably. Consumers, like firms, have been repairing their balance sheets. Also, while consumer indebtedness remains high, so, too, does household net worth—historically so, despite the stock market's recent woes. Finally, while the unemployment rate has not yet begun to fall, its recession peak was at a level below most of the nonrecession rates experienced since the mid-1970s. To the extent that joblessness affects consumer spending, this could be a source of strength going forward.

The Inflation Picture

Finally, we turn to inflation. Since the middle of last year, what had been a significant acceleration in the rate of

consumer price inflation has turned into a sharp deceleration. The September Consumer Price Index (CPI) registered a 12-month inflation rate of 1.5 percent; most core, or trend, measures of CPI inflation are hovering near 2 percent (*Chart 5*). Very low rates of measured inflation, together with falling prices in some CPI components, such as commodities and durable goods, have led to concerns that overall deflation may now be a real danger.

While falling commodity and durable goods prices are not, in themselves, evidence of deflation—and may, in fact, have reasonable explanations in terms of productivity growth—very low overall inflation rates may still warrant concern.

Why should we worry about the possibility of deflation? Economic theory is divided in its view of the consequences of deflation. Many economic models suggest that deflation should be actively pursued, while others suggest that it should be strenuously avoided. Real-world experience seems to favor the latter view. The Japanese experience since the early 1990s, for example, vividly demonstrates the difficulties that can arise in a deflationary environment. As nominal interest rates reach zero, the traditional stimulative tools used by central banks—interest rate cuts—become unavailable, and expansionary policy can only be conducted through extraordinary measures. An economy may find itself mired in a deflationary trap that monetary policy is power-

Chart 5

Consumer Price Inflation Shifts into Low Gear

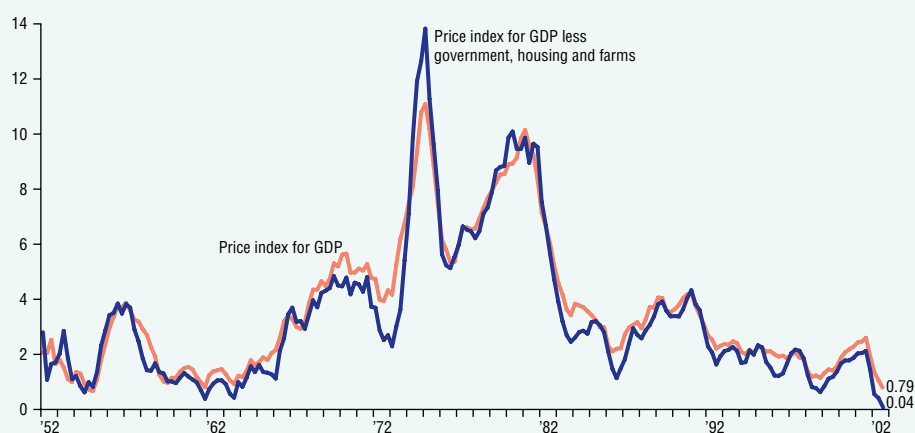


SOURCE: Bureau of Labor Statistics.

Chart 6

GDP Inflation Near 50-Year Lows

Four-quarter inflation rate (percent)



SOURCE: Bureau of Economic Analysis.

The U.S. economy is, by some measures, as close to price stability as it has been at any time in five decades.

less to break. Some caution would thus appear warranted.

But how close are we? With core CPI inflation around 2 percent, it may seem that we're not really that close. However, there may be good reason to view that 2 percent figure as an overestimate of the economy's actual rate of inflation. First, in spite of the many technical improvements made to the CPI over the past several years, it's likely that the index is still biased upward—that is, that it overstates the rate of consumer price inflation. Also, the CPI focuses solely on goods and services purchased by consumers. If one looks at broader inflation gauges—for example, the price indexes for all of GDP or some of its major components—one finds inflation rates near 50-year lows. Those inflation rates are also quite a bit closer to zero, though still positive.

As seen in Chart 6, the current annual inflation rate for GDP less government, housing and farms—at a little over 0.04 percent—is below all but one observation in the past 50 years. The U.S. economy is, by these measures, as close to price stability as it has been at any time in five decades.

What's the bottom line on inflation? By most measures, the economy's overall inflation rate is quite low, but still positive. Given the possible consequences of deflation, though, further declines in inflation may be undesirable. For the past

50 years, price stability—understood as a low, stable rate of inflation—has been pursued by restraining inflation from above. In the current environment, maintaining price stability may entail supporting inflation from below.

Conclusions

Clearly, the presumptive expansion is at a delicate stage. Some of the weakness observed so far is to be expected given the mildness of the 2001 recession, but evidence of recent cooling is a cause for concern. Nevertheless, the data suggest that it is premature to conclude the economy is facing a double-dip recession. Demand has held up thus far and—given the stripped-down state of inventories—may yet carry the day. Finally, the reversal of fortune on the inflation front has put us in a position where maintaining price stability may—for the first time in decades—mean boosting inflation rather than containing it.

—James F. Dolmas

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